INFLATION AND CHINA

The struggle that for years, in the background, has seen the clash between an old economy based on oil, combustion, and thus CO2 emissions and a new green, digitized economy has taken on new form and substance in 2022. The heart of the change is summed up in a phenomenon that seemed to be outdated for modern, open and globalized economies: excessive inflation and the fear of not being able to control it. It is the sharp rise in prices that erodes everyone's ability to buy, but it mostly affects those with limited means to live, while helping those with lots of debts that depreciate over time. Inflation is a monetary expression (with more money I buy fewer and fewer goods), but it is also a form of the spirit, a new way of being; without doing anything what I own retracts along with the vision of the future. For several decades now, rising prices, at least for Western economies, have not been a danger. On the contrary.

The major central banks have been granted independence from political authorities for at least 30 years. They have thus forced themselves to focus on the target of 2 percent maximum annual inflation. The markets took them so seriously that the fear of rising prices dropped off their radar. In fact, the main fear had become deflation, that is, the fear that if a product continues to devalue, people will not spend because they will postpone purchases by waiting for lower prices. Those who have studied and, especially, taught economics in recent decades have not been concerned with the historical dimension of economic facts. They focused on mathematical modeling of reality, and this had little to do with rising prices.

Central banks, notably after the great financial crisis of 2008, discovered that they could constantly bail out the system in times of stress by increasing the money supply. This would have inflated financial instruments (stock exchanges in particular), without creating inflation in the real economy. The increase in investor financial wealth would have stimulated demand in the real economy, but without excess, because it is not the mass that invests in financial instruments and therefore the spillovers into the real economy remain contained. Globalization

has allowed production where costs are lowest, particularly in China. This has decreased the bargaining power of labor in advanced countries. Digitization has rationalized production. And an aging population has contained demand.

All these factors compressed the rise in prices by giving central banks the green light in their policies of extreme financial easing. Near-zero and even negative rates made it possible to overcome the emergency of the great financial crisis of 2009 and then the coronavirus. This policy also opened up new scenarios: the possibility of financing at zero cost the transition to a new green and digitized economy. It was a powerful weapon in the hands of the apostles of the transition that humiliated and kept in check those who defended the tools of the old economy with the sword, particularly the oil and gas exporting countries. The war in Ukraine is also the consequence of these choices: the new economy upsets the old geopolitical balances. To slow down the process, however inevitable, toward a production system capable of containing environmental overheating, the main ally of the old economy's interests is inflation.

Central banks, especially the Federal Reserve, have been unwilling to recognize early on that inflation is the new variable that must also be considered in structural terms and not just "transitory," as Jerome Powell, its chairman, insisted just a few months ago. Thus, financial and fiscal stimuli provoked to prevent a coronavirus collapse of world economies have been maintained for too long. Seeing no danger of structural inflation, cheerful finance has been taken advantage of to feed short-term political or party interests. As Agustin Carstens, general manager of the Bank for International Settlements (BIS), the bank of central banks, admits, "If you had asked me a year ago to lay out the key challenges for the global economy, I could have given you a long list, but high inflation would not have made the cut." [1] Now, however, the influential economist admits that we may be on the crusp of "a new inflationary era (...). Structural factors that have kept inflation low in recent decades may vane as globalization retreats."[2] And

[1] Agustin Carstens, "The return of inflation", Speech, *International Center for Monetary and Banking Studies*, Geneva, 5 April 2022.

[2] Ibidem.

so it becomes necessary for central banks to review their parameters. They can no longer act as they did in recent years when, having tamed inflation, they had unprecedented leeway to focus on growth and employment. "If circumstances have fundamentally changed," Carstens concludes, "a change in paradigm may be called for. That change requires a broader recognition in policymaking that boosting resilient long-term growth cannot rely on repeated macroeconomic stimulus, be it monetary or fiscal. It can only be achieved through structural policies that strengthen the productive capacity of the economy."[3]

Financial markets seem to have taken the measure of the magnitude of the challenge. They have realized that we have entered a new era and therefore other risk assessment parameters must be worked out. But these are not there for now. So, in the uncertainty, which cannot be measured, markets are selling. U.S. stocks, but also bonds, have had their worst five months in fifty years. The S&P went so far as to lose almost 20 percent since the beginning of the year, touching the defining threshold of a bear market. It then recovered and closed at -13%. But the bond market also hit lows it had not seen since 1973. The Nasdaq, the technology index, lost more than 22%. Similar, though somewhat smaller, losses were recorded in Europe, while China, due to lockdowns and direct control policy, particularly on technology companies and real estate, closed the month at -17% (CSI300), but only after a good recovery in recent days. The classic "sell in May" has therefore already been there. Is now the time for recovery? Will we have a better second half of the year than the first?

The problems of the near-first half of the year will not go away in the second half. Central banks are trying to scare markets away from screwing up inflation and dragging with it wage claims that, once they get going, are difficult to scale back. The war in Ukraine does not seem to find a near end. So, it will continue to weigh on inflation through hydrocarbon prices. Ukrainian steel mills, because of their size, are also large producers of neon gas, which is used to process microchips (they account for 75 percent of global demand). Well, half of the world's neon production may soon fall under Russian control (there are only one to six months of reserves of

[3] Ibidem.

this gas). Putin has already commandeered much of what was found in Mariupol. Phenomena like this, unresolved, are a huge danger to the stability of the world economy, could delay the restart or, in any case, further affect prices. [4]

In the United States there is a growing belief that inflation has peaked. In Europe, due to commodity prices, inflation reached 8.1 percent in May (7.4 percent in April). This divergence is also reflected in the currency sphere: the euro has strengthened against the dollar because the European Central Bank is also expected to raise rates at its next meeting. It is possible that the bond market, which is structurally more "intellectual" than the stock market, has already interpreted the near future. The equity one is struggling more to find the new equilibrium from which to restart. A good rebound after the travails of May fits. However, it is too early to think of a change of scenery (barring unexpected events such as the end of the war in Ukraine).

Larry Summers, former president of Harvard University and former economic adviser to Barack Obama, looking at history says that inflation above 4 percent and unemployment below 5 percent have always resulted in a recession in the next two years. This is possible. But in the new planetary balances, China's role can change the course of the world economy. The end of lockdowns and the beginning of major monetary and fiscal policies (with 2 percent inflation it can afford) could keep the world economy on good levels of growth. If this occurs, at the same time as inflation falls, the Fed may be ready to slow its monetary tightening in September. And perhaps announce that the 2 percent inflation target is unrealistic in the new, partially de-globalized world. Financing the new economy now requires a focus on growth and productivity even at the cost of accepting higher levels of inflation. But without China's contribution, Summers' thoughts are likely to be correct.

Translated with ww.DeepL.com/Translator/CSM

[4] Zoltan Pozsar, *Commodity Chokepoints and QT*, Credit Suisse, 29th April 2022.